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Monetary Policy: The Inflation-Unemployment Tradeoff

Levy Institute

The Jerome Levy Economics Institute of Bard College

MONETARY POLICY: The Inflation-Unemployment Tradeoff

CONFERENCE PROCEEDINGS

Including speeches by

David A. Levy, Vice Chairman and Director of Forecasting, The Jerome Levy Economics Institute of Bard College

The Honorable Laura D'Andrea Tyson, Chair, Council of Economic Advisers

The Honorable Bill Bradley, United States Senate

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FOREWORD

As the U.S. economy continues to recover, the relationship between employment creation and price stability becomes the focus of economic policy. Policy actions by the Federal Reserve have rekindled the debate, first, over what is the appropriate course of monetary policy and its relationship to the inflation-unemployment tradeoff and, second, whether such a tradeoff indeed exists. Citing the instability in the financial markets attributed to expected inflation, the Federal Reserve brought about six increases in the federal funds rate between February and mid-November of 1994.

To explore the policy implications of these actions, The Jerome Levy Economics Institute of Bard College convened a conference entitled "Monetary Policy: The Inflation-Unemployment Tradeoff" in Washington, D.C., on November 17, 1994. We hope the presentations and discussion that took place at the conference, summarized here, will provide a better understanding and evaluation of issues and questions related to monetary policy.

We thank the participants for their thoughtful contributions and all those people whose dedication and hard work helped make the conference a notable event.

Dimitri B. Papadimitriou
Executive Director
The Jerome Levy Economics Institute of Bard College

SPEAKER

The Federal Reserve: Securing Our Future or Jeopardizing It?

A presentation by
David A. Levy
Vice Chairman and Director of Forecasting,
The Jerome Levy Economics Institute of Bard College

The title of this conference is "Monetary Policy: The Inflation-Unemployment Tradeoff." Yet there is no tradeoff, according to some people, including a number of the central bankers and economists at an international conference at Jackson Hole in August. They argued that monetary policy cannot control unemployment and that central banks should focus on price stability alone.

Then, in words heard around the financial world, the Federal Reserve's recently appointed vice chairman made the outrageous suggestion that sometimes central banks ought to give unemployment some heed—which, incidentally is required by U.S. law. Because the news media exposed this blasphemous remark, Alan Blinder spent the next few weeks trying to convince the capital markets that he is not a financial anarchist.

To those who say that central banks should focus narrowly on price stability, that the inflation-unemployment tradeoff is too broad a framework for formulating monetary policy, I must protest: On the contrary, this framework is far too limited. Monetary policy can have a multitude of profound effects on the economy and society. Before the people of the United States allow the Federal Reserve to repeatedly jack up interest rates in the pursuit of price stability, we should demand that the following questions be considered:

1. What effects will monetary policy have on unemployment?

2. Does the Federal Reserve have a systematic and effective method of choosing the monetary policy that will attain its goal?

3. What is the impact of Federal Reserve policy on federal deficit reduction?

4. What impact will monetary policy have on the nation's international current account deficit?

5. If monetary policy keeps the unemployment rate above 6 percent to prevent inflation, what are the long-term consequences for our society?

6. Should the Federal Reserve put a ceiling on growth in the standard of living?

7. Is monetary policy ethical?

8. How serious is the current inflation threat, and does it justify the costs and risks of aggressive monetary policy?

Question 1: What effects will monetary policy have on unemployment? The notion that unemployment is unrelated to monetary policy is absurd. Federal Reserve actions cannot *control* unemployment, but they certainly *affect* joblessness. All central banks—even the Bundesbank—consider unemployment. That is why they ease during recessions.

Monetary policy cannot restrain inflation without weakening the economy and curbing employment. To see why, let's think about the inflation process. Why do sellers raise prices? Either to increase their profit margins or to protect margins after an increase in costs. Thus, the two basic types of inflation are *widening profit margins* and *increasing business costs*. To stem inflation, a tightening of monetary policy must compress profit margins or limit cost increases or both. It does both, but not without curtailing employment. Raising unemployment is the Federal Reserve's primary means of fighting business cost inflation, and increased joblessness is an inexorable consequence of squeezing profit margins.

Let's take a closer look. Monetary policy reduces business cost inflation primarily by curtailing advances in labor costs, which are by far the largest and most important of all business costs. In idealized, orthodox economic theory, near-perfect markets work so well that a small reduction in the pace of monetary growth slows the pace of wage and salary hikes, and all the while equilibrium forces prevent the economy from straying far from full employment. In reality, the only way that Fed rate hikes can influence the size of pay increases is by hindering economic activity sufficiently to cause a marked increase in unemployment and a decrease in job security.

The influence of monetary policy on other business costs is mixed and has much less impact on inflation. For example, Federal Reserve rate hikes tend to strengthen the dollar and lower the cost of imported goods, but they also increase businesses' interest expenses. The business sector is a net interest payer.

Profit margins account for only a small fraction of prices, but abrupt changes in profitability can make substantial, if brief, contributions to general inflation. Also, stable but excessively high profits can lead to labor and other shortages, causing firms to bid up employee compensation rates.

By raising interest rates, the Fed can compress profit margins. Figure 1 shows the equation for total business profits, which is the saving-investment identity rearranged to isolate net business saving. Net business saving is profits after taxes and dividends. Rising interest rates affect all the terms on the right and therefore affect total profits. The dominant effect is through investment; rising interest rates eventually reduce investment, which reduces profits. However, Fed rate hikes affect profits in complex ways through all of the terms in this equation, so monetary policy is a highly imprecise tool for regulating profit margins.

Since profits typically account for less than 10 percent of prices, Fed policy must reduce profit margins by over 10 percent in a year to offset 1 percent of inflation. Such a decline represents a significant deterioration in the business climate and would have a sizable impact on employment.

We can pretend that monetary policy controls inflation painlessly without raising unemployment. We can tell ourselves that Fed actions "lower inflationary expectations" without applying the brakes to economic growth and job creation. But except for the financial markets, almost no one forms inflation expectations based on what the Federal Reserve does; I would like to meet the employee or the union representative who reduced the size of the pay raise he was seeking or a firm that altered its pricing strategy the day after a Federal Reserve tightening.

Thus, the Federal Reserve does face a tradeoff between unemployment and inflation, at least in the short run. Tightening credit combats inflation by squeezing profit margins and increasing unemployment—by weakening the economy. To affect prices significantly through either channel, the Fed has to engineer a significant change in the profits trend and to soften labor markets materially. Monetary policy should not be formulated in a vacuum without addressing the question, "How much employment, profits, and growth are we willing to sacrifice for a given reduction in inflation?"

Question 2: Does the Federal Reserve have a systematic and effective method of choosing the monetary policy that will attain its goals? Once we assign priorities to price stability and job creating, we need to ask question 2. The answer is an emphatic no.

I will leave the arguments largely to my Levy Institute colleagues, Dimitri B. Papadimitriou and L. Randall Wray, the authors of the *Public Policy Brief* entitled, *Monetary Policy Uncovered*, "Flying Blind: The Federal Reserve's Experiment with Unobservables." Dimitri and Randy trace the history of modern Fed intervention and show that every method tried or seriously considered—targeting M1, M2, M3, P-star, gold, and so on—has turned out to have serious problems, leaving the Fed, in the candid words of Governor Larry Lindsey, to "look at a whole raft of variables—we ignore nothing and focus on nothing" (*New York Times*, February 28, 1994). Yet it is advantageous for the Fed to provide a rationale for its actions to Congress, and Chairman Greenspan has emphasized *real interest rate* targets this year. Dimitri and Randy try to apply Mr. Greenspan's suggested rule in their paper and found that it generates notably poor results.

The explanations and rationalizations of monetary policy sometimes become so esoteric that it is tempting to ignore them and just look at the record. Figure 2 shows the federal funds rate, with the shaded areas indicating recessions. An observer who knew nothing about the rationale for monetary policy and had to guess what it was would say that the Federal Reserve begins raising interest rates after an expansion is underway, keeps on raising them until the economy gets into serious trouble, and then cuts rates. Serious trouble usually has meant a recession, although occasionally the economy has only slowed, as during the so-called growth recession of 1967 and the so-called rolling recessions of 1984 to 1986. Neither this record nor the absence of method in Federal Reserve policy decisions inspires confidence that the central bank can manage inflation without causing havoc.

Question 3: What is the impact of Federal Reserve policy on deficit reduction? One of the great mysteries of our time is how, in the midst of near hysteria over deficit reduction, with government assailed at every turn for spending the taxpayers deeper and deeper into debt, one U.S. agency, the Federal Reserve, lumps tens of billions of dollars onto the annual deficit at will—and remains virtually unscathed by criticism.

The Fed raised interest rates six times this year, a total of two and one-half percentage points. After not one of those occasions did I see a headline that said, "Central Bank Raises Rates, Adds Billions More to Federal Deficit." But when the Federal Reserve tightens credit, it widens the federal deficit both directly, through higher federal interest payments, and indirectly, through reduced tax revenues and increased economic assistance outlays.

The impact on federal interest outlays is considerable. Approximately $1 trillion of federal debt is either refinanced or added every year. Adding 250 basis points to the interest rates on these new Treasury securities increases the federal interest payments by about $25 billion within a year. Moreover, the longer interest rates remain elevated, the greater will be the share of Treasury debt affected by the rate hike. Thus, an ongoing anti-inflation vigil by the Fed, as during the 1980s, has a long-term, cumulative effect on federal interest payments. Figure 3 shows the federal government's net interest payments as a percentage of GDP. The steep rise in the late 1970s and early 1980s reflects in large part the jump in interest rates engineered by the Volcker Fed. The decline in payments of the early 1990s, despite continued, large deficits, reflects the steep 1989 to 1992 rate decline.

Moreover, if Fed rate hikes keep profits 10 percent below what they would otherwise have been, the government loses corporate income tax revenue at a $15 billion annual rate. If monetary policy reduces the annual collection of personal income and social security taxes by 1.5 percent, the government deficit rises by $17 billion. Add a few billion dollars more for unemployment insurance and other cyclical outlays. The bottom line is that tight money policies that are potent enough to seriously affect price trends add tens of billions of dollars to deficit spending—even without creating a recession.

Question 4: What impact will monetary policy have on the nation's international current account deficit? Repeated, large U.S. trade deficits in the 1980s wiped out America's formerly huge net holdings of foreign assets. In 1988 the United States became a net debtor country, making headlines and provoking hand-wringing. Since then, our international balance sheet has been all but forgotten, and the trade gap makes headlines only as a "jobs" issue. But our net foreign debt keeps growing, as shown in Figure 4, and a new problem is developing: a widening deficit in factor income payments as more profits, interest, and dividends flow out of the country to foreigners than flow in (Figure 5).

Two economists at the Levy Institute, Wynne Godley and William Milberg, have analyzed the implications of continuing large current account deficits. Their results will be published in a forthcoming Levy Institute *Public Policy Brief* and, in condensed form, in the November-December issue of *Challenge* magazine. They conclude that a continuation of current trends would increase the net outflow of factor income to over 1 percent of GDP by the year 2000 and about 2 percent by 2005. These trends are not sustainable, and, as the authors argue, the longer they go on, the greater the pressures for a plunge in the dollar and the more serious the domestic and international implications.

The Federal Reserve is aggravating this problem in a number of ways. Rising interest rates are delaying currency adjustments and increasing the volume of interest payments flowing out of the country. The Fed and other G7 central banks have also delayed currency adjustments by intervening directly in the foreign exchange markets in defense of the dollar. Given our stubborn current account imbalance, trying to keep the dollar from weakening to avoid the inflationary impact of higher import prices is akin to avoiding the dentist when you know you have a cavity. The longer you wait, the more painful the remedy. Moreover, by maintaining high interest rates and inhibiting growth, the Federal Reserve is hindering capital investment and impeding American competitiveness.

Question 5: If monetary policy keeps the unemployment rate above 6 percent to prevent inflation, what are the long-term consequences for our society? There is reason to suspect that chronically high unemployment may breed unemployability as well as a wide range of social problems. Economists today talk about "full employment" when 5.5 to 6.5 percent of the labor force is jobless; 20 years ago 3 or 4 percent was the goal. The change represents an increase in those allegedly unable to contribute productively to the economy as employees—a rise in the so-called structural unemployment rate.

Many people think that the ill-named natural rate of unemployment, allegedly about 6 percent, should be the minimum rate allowed. But unless business cycles ceased to exist, the unemployment rate would then range from 6 percent up, so that the average unemployment rate might be 7 percent or higher.

Unfortunately, the higher the unemployment rate over a period of years, the greater will be such social problems as impoverished single-parent households, school dropouts, substance abuse, gang membership, crime, illiteracy, and cultural alienation. When unemployment rises a little nationally, it expands a lot more in distressed communities and social problems increase. Young adults emerging from these environments are more prone to remain outside the economy and alienated from society. The research and analysis in these areas by William Julius Wilson, Richard Freeman and Harry Holzer, Robert Haveman, Christopher Jencks, and many others are not generally viewed as required reading for Federal Reserve governors. Perhaps they ought to be.

Even if one feels no concern for the people so excluded from the economy, one should not disregard the costs of the disenfranchised on all of us such as crime, higher insurance premiums, increased security needs, and other economic and quality-of-life costs. At issue is not whether the government should spend more money on aid to the poor, but whether the Fed should prevent the private economy from providing jobs that could keep more people constructively engaged in our society.

Question 6: Should the Federal Reserve put a ceiling on growth in the standard of living? A disturbing, often asserted objective of monetary policy is to limit the economy's growth to a "sustainable," noninflationary pace. The Fed is supposed to act as the highway patrol, enforcing the speed limit as the economy motors along the expressway. The notion that the Fed can fine-tune growth is disturbing enough, but when tight-money advocates proclaim that the speed limit should be 2.5 percent, we really have a problem.

A growth rate of 2.5 percent growth does represent about what has happened over the past quarter century. However, economic growth is uneven. A long view of history reveals there are decade-long or multi-decade periods of vibrant growth, extended depressions, and spells of stagnation, as illustrated in Figure 6.

The notion that 2.5 percent is a maximum, sustainable rate for the economy assumes that the future will be a replay of the rather dismal performance of the past 25 years. Some of you may be familiar with Jay Levy's and my writings on the contained depression of the 1990s and the prospects for a long, vibrant period to begin by the turn of the century. I would argue that growth over the next generation is more likely to average 4 percent than 2.5 percent. But even if we merely agree that the growth potential is uncertain, do we want the Fed to fight growth aggressively anytime the economy expands at a rate faster than 2.5 percent?

Consider what would have happened had the Federal Reserve limited growth to 2.5 percent from 1946 to 1966. Real GDP would have increased by a total of only 64 percent instead of 101 percent. The standard of living of the average American in 1966 would have been more than one-fifth less than it actually was. During these years average annual inflation was about 2 percent; had the Fed been able to assure 0 percent inflation and 2.5 percent growth, would the absence of this modest inflation have justified the lost purchasing power? How many Americans would take a 21 percent cut in their standard of living to avoid the nuisance of 2 percent inflation? Moreover, interest rates, especially after adjusting for inflation, would have been chronically higher. Residential construction and business investment would have been weaker, productivity gains would have been smaller, and the position of the United States in world markets would have been less dominant. Unemployment would have been higher, and the absorption into the labor force of millions of discharged veterans would have been much slower and more troublesome. The nation's debt-to-GDP ratio would not have dropped from a huge 117 percent in 1946 to 34 percent in 1966. Americans, who just a few years earlier had lived through the Great Depression, might well have thrown out of office the public servants who allowed the Federal Reserve to perpetuate high interest rates, high unemployment, and obstacles to business prosperity.

Question 7: Is monetary policy ethical? Is it right to limit profits, growth, and employment in an effort to fight inflation? Do we have a concept of economic justice when setting economic policy, or do we just balance conflicting political forces? Does the good of the majority come before the rights of the minority and what are those rights? There are some moral principles inherent in capitalism, such as "Individuals should be free to make choices" and "Economic rewards should be based on contributions to production." This country has long exalted justice and individual rights, and it seems that some examination of the ethical justification should be required before pursuing a policy of planned unemployment.

Question 8: How serious is the current inflation threat, and does it justify the costs and risks of aggressive monetary policy? Preventing inflation is a legitimate concern for the United States, as anyone living on a fixed income during the 1970s could testify. Inflation redistributes income in an arbitrary and often unfair manner. It hurts retirees and other pensioners. It obfuscates fairness in pay negotiations and adds uncertainty to business decisions. It also distorts tax policy, makes financing and owning a home more speculative and risky, destabilizes currency markets, and generally discourages economic activity by creating uncertainty about future inflation, interest rates, exchange rates, and asset values.

Nevertheless, America is gripped by a fear of inflation that is far out of proportion to the dangers. Consider the record of postwar inflation (Figure 7). Note that every wiggle does not portend a new inflationary or disinflationary trend.

There are good reasons to expect prices to remain well behaved in the 1990s. Labor cost increases have been and are likely to remain small. The United States has regained what it lost in the late 1960s and 1970s, a culture of wage stability, which is reflected in the employment cost index (Figure 8). The current business-labor culture stresses price stability and pay related to productivity. Most firms have great difficulty in passing along higher costs to their customers because of keen competition from domestic and often foreign companies, and workers are more aware than they have been in years that their jobs depend on the competitiveness of their employers. Firms have institutionalized cost-reduction goals in every area from purchasing to production to sales, and managers who have gone through the painful experience of shedding employees are loath to become loose with their budgets again. Capacity utilization data, which some observers claim indicate the imminence of inflationary bottlenecks, seriously understate the production potential of U.S. manufacturers, as idle overseas capacity is formidable.

Taking a longer view, the United States will undoubtedly be challenged with rising commodity prices and other inflationary shocks, but these will not necessarily lead to prolonged increases of inflation. Nor will viciously tight money necessarily be the key to preventing inflation from acquiring inertia.

While monetary policymakers do indeed face an inflation-unemployment tradeoff in the short term, the issue is more complicated in the long run. For instance, the country most noted for growth and low unemployment in the postwar era is Japan, where inflation has been modest (Figure 9). Notice that the inflation rate exhibited considerable cyclical movement but its trend remained subdued. There is a widespread failure in the United States to recognize that cyclical acceleration in inflation does not automatically imply a rising secular trend. In Japan, even the great oil shock of the 1970s did not have a long-term effect. And Japan did not rely on high unemployment to keep inflation in check.

In our country the long-term tradeoff, if it exists, has been overridden by other factors, as shown in Figure 10. Here we divide the postwar era into three periods to isolate the high inflation years, and we see that low inflation can accompany slow growth or fast growth and that high inflation can be paired with slow growth.

(Unemployment is generally linked to economic growth, although labor force demographics are also important.)

Clearly, there is more to low inflation than monetary policy. A good place to begin a search for policies to promote long-term prosperity without inflation would be the observation that countries experiencing rapid growth, low unemployment, and price stability over long periods have small, stable nominal pay increases because workers are gratified—real wages rise significantly year after year.

The United States should reject the arguments of those who would exclude unemployment from the monetary policy debate. We should also insist on the inclusion of numerous other important issues: the national debt, the nation's international indebtedness, U.S. competitiveness, standard of living, social stability, quality of life, ethics, and a broader consideration of what constitutes an inflation threat and what alternatives might exist to chronic monetary drag.

Figure 1 Total Profits Equation

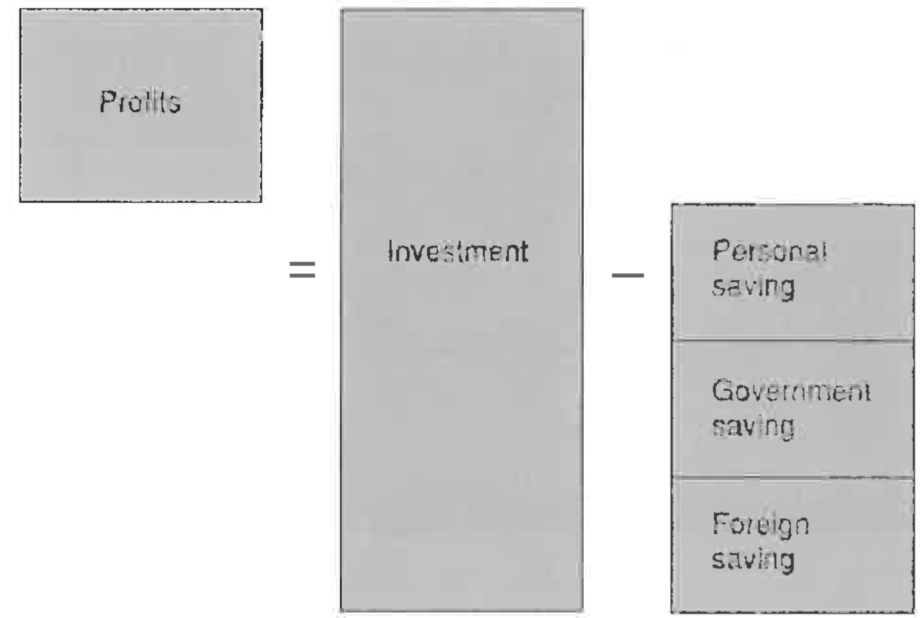
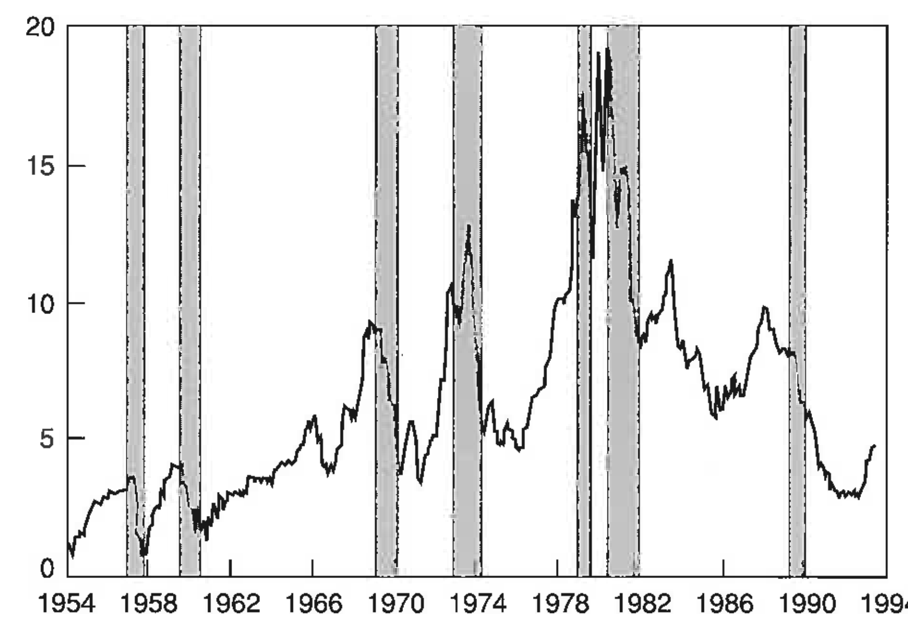
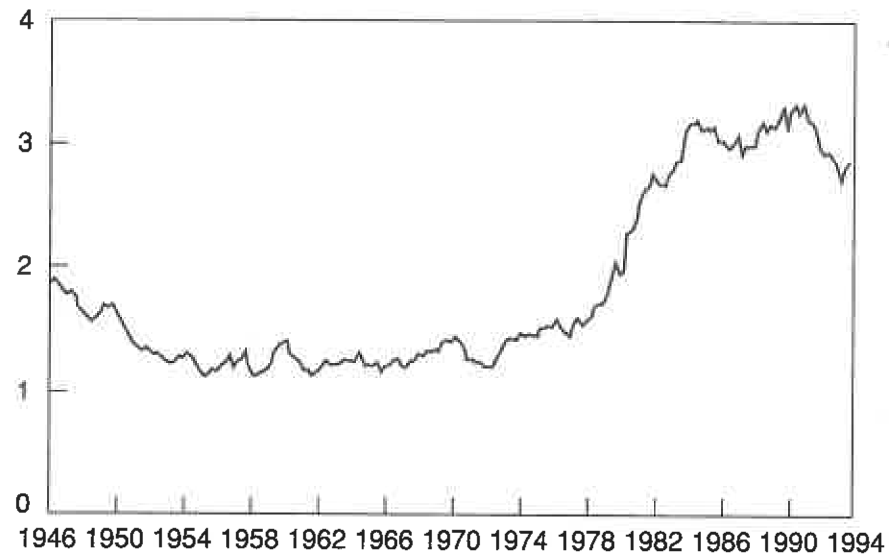


Figure 2 Federal Funds Rate (Shaded areas represent recessions.)



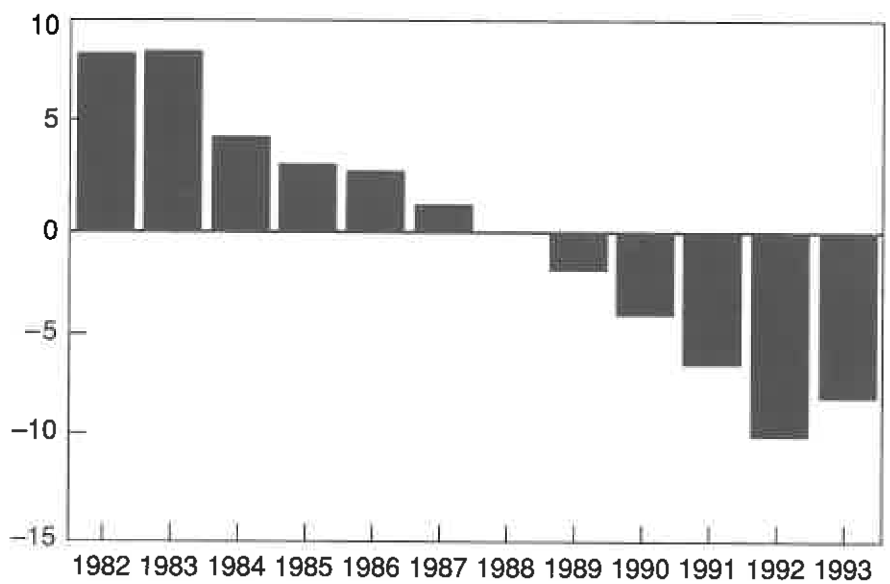
Source: Federal Reserve Board.

Figure 3 Net Interest Paid by Federal Government as a Percentage of GDP



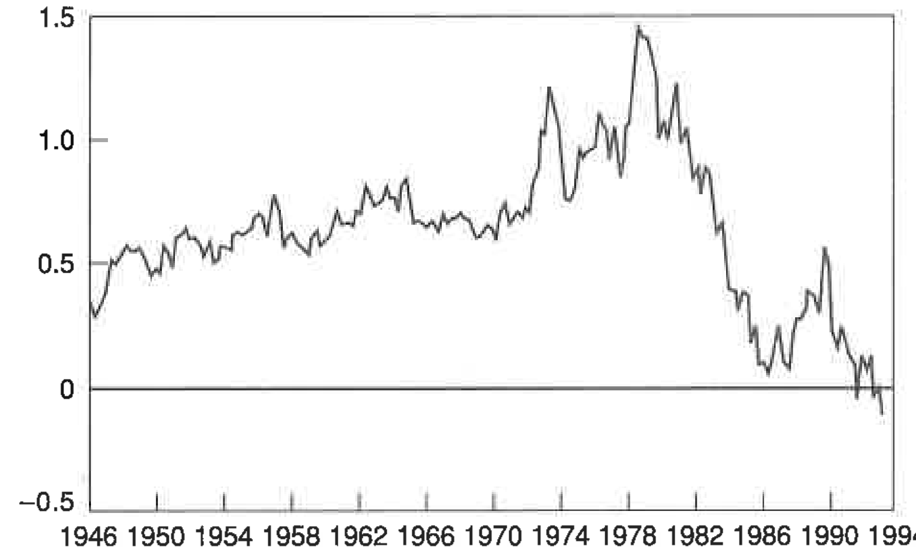
Source: National Income and Product Accounts.

Figure 4 Net Investment Position of the United States as a Percentage of GDP



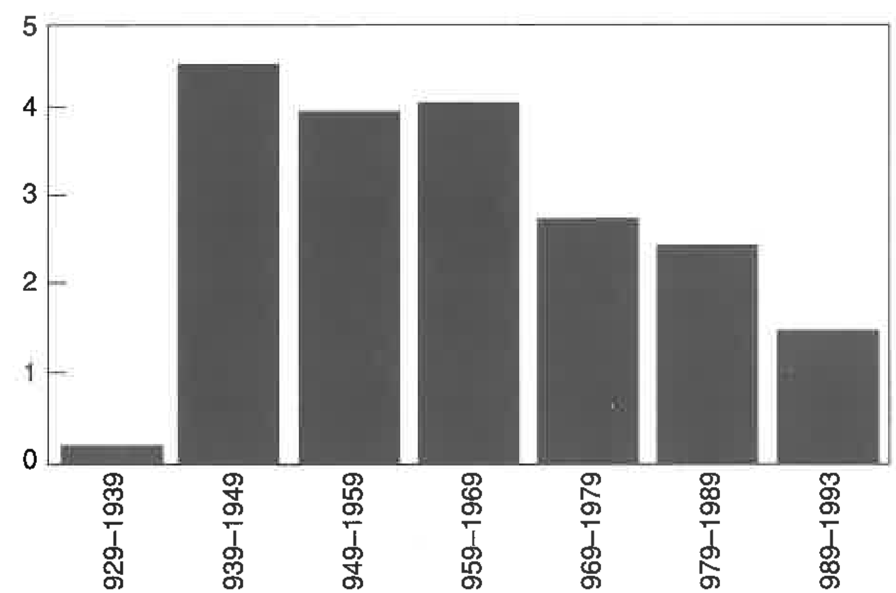
Source: National Income and Product Accounts, *Survey of Current Business*.

Figure 5 Net Factor Income as a Percentage of GDP



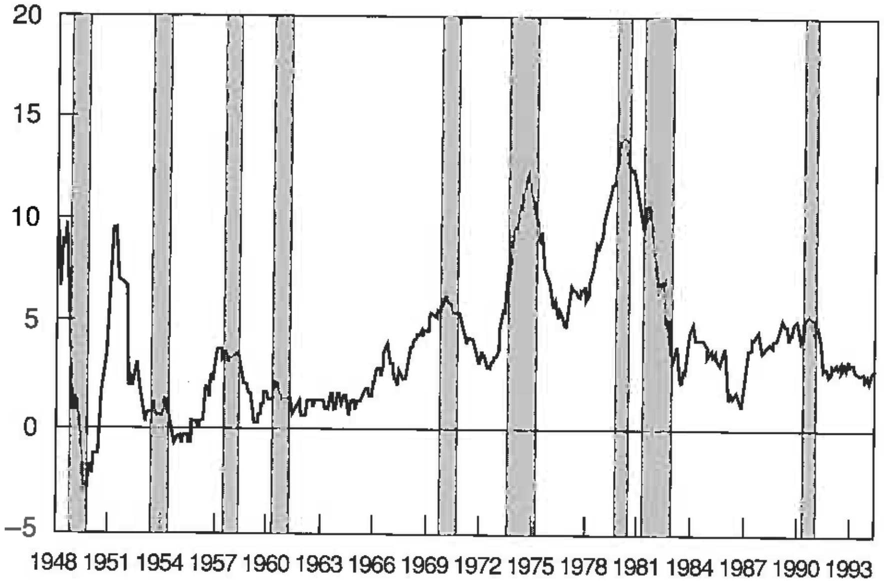
Source: National Income and Product Accounts.

Figure 6 Average Annual Growth in Real GDP



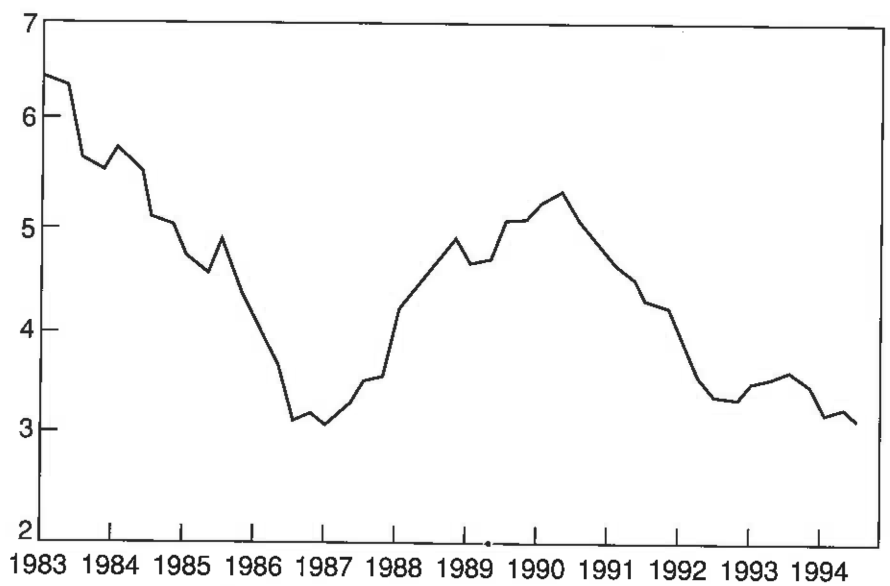
Source: National Income and Product Accounts.

Figure 7 Consumer Price Index, 12-Month Percent Change (Shaded areas represent recessions.)



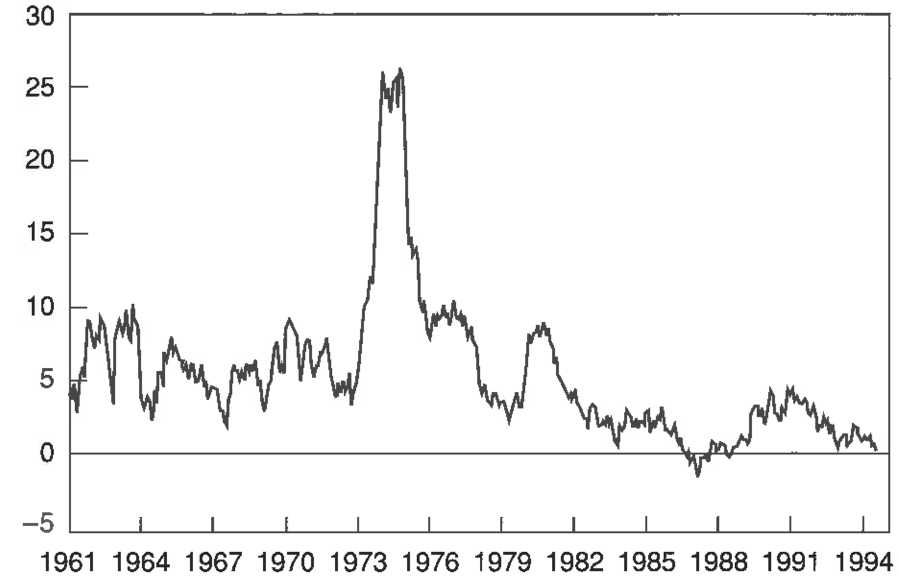
Source: Bureau of Labor Statistics.

Figure 8 Employment Cost Index, 12-Month Percent Change



Source: Bureau of Labor Statistics.

Figure 9 Japanese Consumer Price Index, 12-Month Percent Change



Source: Organization of Economic Cooperation and Development (OECD).

Figure 10 Inflation-Unemployment Tradeoff?

	Real GDP Growth (percent)	Unemployment Rate (percent)	CPI Inflation (percent)
1947–1967: fast growth, low inflation	3.9	4.8	2.0
1968–1981: slow growth, high inflation	2.5	6.0	7.7
1982–1993: slow growth, low inflation	2.9	7.0	3.7

Note: All figures are annual averages.
Source: Author's calculations based on data from the National Income and Product Accounts, Bureau of the Census, and Bureau of Labor Statistics.

SPEAKER

A presentation by
The Honorable Laura D'Andrea Tyson
Chair, Council of Economic Advisers

It's very nice to be with you today. I want to begin by painting a picture of where I believe the U.S. economy is today and then talk to you a little bit about where we (the Clinton administration) believe it is going. But to paint the picture, I want to start with the problems we have been trying to address during the last two years.

First, if you go back to November 1992, you will recall that although the economy was formally in a recovery period dated from the spring of 1991, the recovery was, by most estimates, a sub-par recovery both in terms of the growth rate and, therefore, in the creation of jobs. At that time we used the jobless adjective to describe the recovery. It was fairly clear, by any calculation comparing it to previous recoveries, that it was a sub-par, sluggish, jobless recovery.

In addition, slow growth was accompanied by a ballooning federal budget deficit. Between the first quarter of 1989 and the first quarter of 1993, the deficit had jumped by $173.5 billion. Meanwhile, during that period the national debt continued the climb it had begun in 1981 when the so-called supply-side miracle of large tax cuts combined with large spending increases turned the nation from a creditor nation into a debtor nation in record-breaking time and caused the national debt-to-GDP ratio to double.

The third problem we saw, and one that is still with us today, is the problem of faltering productivity growth and its translation into a 15-year stagnation in real median family income. Those were the problems as we saw them.

Two years later the short-term economic situation—the cyclical economic situation—is obviously far brighter and far stronger than it was two years ago. Moreover, the nation has begun to take steps to address the longer-term problems.

Let me review some of the successes and changes that have occurred over the past two years. I'll begin with the one that is most obviously under the federal government's direct control, and that is the behavior of the budget deficit. According to our forecast and the forecast of the Congressional Budget Office, the deficit will decline in fiscal year 1995 for a third consecutive year. Moreover, the numbers that just came out a couple of weeks ago for fiscal year 1994 show the deficit to be down $50 billion compared to fiscal year 1993 and about $100 billion compared to what the Congressional Budget Office had forecast back in early 1993.

The deficit-to-GDP ratio will be cut in half. If you look at 1992, the deficit-to-GDP ratio was 4.9 percent; next year it will come in, we believe, at 2.4 percent. Moreover, that ratio (2.4 percent), which has not been seen in this economy since 1979, will persist, according to our projections and to current CBO projections, more or less unchanged through the rest of this decade. So we've brought the deficit down. We've cut the deficit-to-GDP ratio in half, and it basically stays there, according to our projections, through the rest of this decade. Again, these are levels not seen in this economy since 1979.

Overall, the debt level will be nearly $700 billion lower by the end of 1998 than it would have otherwise been as a result of the spending cuts and revenue increases introduced by the Omnibus Reconciliation Act of 1993 (OBRA 1993). Of the total $700 billion in debt reduction, about 90 percent will be from policy change and about 10 percent from the cyclical performance of the economy.

Perhaps for a group like this the most important number to point out is the structural deficit-to-GDP ratio, which is a better measure, of course, of the net fiscal status of the government. The structural deficit-to-GDP ratio will be cut by just about a percentage point as a result of policy decisions embodied in OBRA 1993. This is a result of policy decisions on both the spending side and on the revenue side. On the spending side, a steady decline in discretionary government spending is a reason the deficit is falling. Since the end of 1992 federal government purchases of goods and services have fallen at an annualized rate of more than 5 percent, while the rest of the economy has been growing at an annualized rate of over 4 percent.

During this period, incidentally, business spending on producer's durable equipment, which has hit a postwar high relative to GDP, has been growing at an annualized rate of about 17 percent. In fiscal year 1995 federal government spending on goods and services as a percentage of GDP will fall to a 16-year low. By 1998 domestic discretionary spending as a share of GDP is slated to fall to a 30-year low.

So we have had some real spending cuts, and, of course, those spending cuts have been associated with personnel reductions. We have cuts on line of over 250,000 personnel at the federal employee level; we've already cut 71,000 positions.

Now, that's the fiscal policy reality of the past two years. The sound fiscal policy that I've just described has been the foundation for a buoyant and balanced expansion of the private sector economy. As the government has scaled back its actual and anticipated borrowing needs, more resources have become available to the private economy.

People often ask, particularly in light of the current level of long-term interest rates, about the administration's deficit reduction plan. They wonder what has actually occurred with respect to spending cuts and revenue increases and whether they really have an impact on financial markets. I believe the answer is yes, the administration's plan of spending cuts and revenue increases has reduced the deficit premium, the premium in long-term interest rates resulting from the anticipated borrowing needs of the government. Moreover, if you listen to what people say about the increase in long-term rates this year, they do not talk about the borrowing needs of the U.S. government, they talk about other things. They talk about the strength of the U.S. private sector. They talk about the strength of the global expansion. They talk about the decline in net national savings rates in other advanced industrial countries.

We have estimated an increase in the national savings rate, resulting from the reduction of the structural budget deficit, of about one percentage point of GDP. According to this interpretation, long-term interest rates around the world would be even higher if it were not for the deficit reduction actions taken last year and anticipated to continue on a credible path through 1998. This interpretation has been expressed and shared in public comments made by as diverse a group as Paul Volcker, Bob Reischauer, Alan Greenspan, Allen Sinai, and others.

The effects of deficit reduction on the economy—on anticipated borrowing needs, on the pattern of low, long-term interest rates last year, and on the expectations of the business sector here and around the world—have been the basis for some of the very good short-term cyclical results. The economy, as you know, has grown by more than 4 percent over the last year. Personal incomes have increased more than 6 percent. Investment in plant and equipment has surged.

Since January 1993 the economy has generated almost 5 million jobs. The rate of growth of private sector employment payrolls has been greater and faster during this period than during a corresponding period of the much-praised Reagan recovery. Moreover, the quality of jobs seems to be improving.

The Department of Labor has started, on a monthly basis, to look at the issue of the quality of jobs by comparing the median wage of jobs created and the overall median wage in the economy. It has determined that in the first 10 months of this year the economy has generated more high-quality jobs by that definition than in the previous five years combined. So the shift toward more manufacturing jobs, more construction jobs, more high-value added and high-wage business services jobs has really shown up in the quality of employment.

Finally, on the productivity side, the current expansion has been characterized by strong productivity growth. We have had productivity growth that looks to be comparable to that realized in periods of economic expansion in the 1980s. But there is some evidence suggesting (although it is yet impossible to confirm) that we may, in fact, be undergoing a period of secular increase in the productivity growth rate, which would be good news indeed for the U.S. economy.

The current expansion, based on the sound fiscal foundations that I described before, is now, by normal methods of counting, middle-aged; it is more than three years old. Middle-age sometimes, though not always, is associated with certain kinds of infirmities. Nonetheless, the administration, and other private sector forecasters, predicts that this expansion will continue over the medium term.

It is true that almost all forecasters expect some moderation in the growth rate next year, and most suggest that the inflation rate may register a small cyclical uptick next year. For example, the most recent administration forecast, which is still the administration's official forecast, suggests that the GDP growth rate next year, on a fourth quarter to fourth quarter basis, will be 2.7 percent, compared to the 3.0 percent forecast for this year.

On the inflation side, we have a forecast for this year, which seems to be on target, a 2.9 percent increase for the consumer price index on a fourth quarter to fourth quarter basis. For next year our forecast right now is a 3.2 percent increase for the consumer price index on a fourth quarter to fourth quarter basis. The administration's forecast is similar to the Federal Reserve forecasts and other major forecasting agencies. So, it is a nearly consensus view that the expansion will continue. The growth rate will moderate somewhat. There may be a small cyclical uptick in the inflation rate. Altogether, these forecasts are suggesting the economy will experience a moderation in growth and that the expansion will continue.

At first glance this kind of prediction may seem somewhat Pollyannaish. After all, think about the normal behavior of the U.S. economy: It approaches potential, as it has this year; it continues to grow faster than potential for some time; inflation heats up; interest rates rise; and the economy teeters and sometimes falls into a recession. Indeed, almost every postwar expansion in the U.S. economy has ended with a sharp rise in interest rates and that rise has been the proximate cause of much slower growth or teetering into a recession. The record, of course, is similar throughout the advanced industrial world. There's nothing unique here about the United States.

But the current period of expansion in the United States does differ in some critical respects from recent previous expansions. First and foremost, fiscal policy is much more restrictive at this stage of the business cycle and at this stage of output utilization than is normally the case. We have fiscal restraints in place, and they are slated to stay in place unless some unforeseen things develop. This will be the basis for a continued, moderately paced, private sector expansion that does not run the risk of overheating the economy.

In addition, corporate restructuring has continued. We have had some promising signs that the productivity growth rate may experience some secular, as opposed to just cyclical, uptick. We also have a much improved competitive position of the U.S. economy in global markets, attested to by a number of different observers and studies, including most recently the Council on Competitiveness, a private sector research group here in Washington. Another thing that can act to sustain the U.S. expansion through the coming years is the greater-than-anticipated pickup of economies around the world. The U.S. expansion is now supported and complemented by a global expansion that has picked up pace at a faster-than-anticipated rate this year.

All of this is not to deny that as the economy continues to operate close to capacity, the administration and other observers must be mindful of any signs of mounting inflationary pressure. Given what we have seen so far, fear of a significant increase in the inflation rate appears to be unwarranted.

If you look at the forecasts for the U.S. economy, you will see the kind of increase suggested by our forecast: from a little less than 3 percent this year for the consumer price index (CPI) to a little over 3 percent next year. That is hardly what you would call a major change in the inflationary picture of the U.S. economy.

So we conclude that the fears of a large uptick in the inflation rate appear to be unwarranted. Commodity prices have certainly increased during the last year, but as everyone knows, they are not a reliable signal of overall inflation. The capacity utilization rate is high. It is at a 14-year high; it is close to 85 percent, compared to a postwar average of 82 percent. But few industries have significantly increased their prices. So far this year the core producer price index (PPI) for finished goods has risen at an annual rate of only 1.5 percent. Moreover, despite obvious strength in the labor market, there is little, if any, indication, of intensifying inflationary pressure from labor costs. The annual increase in unit labor costs over the last year was 0.6 percent. That is among the lowest annual increases in three decades. The rate of increase in the employee compensation index (ECI) in 1994 has been running at 3.1 percent. That is lower than the rate in 1993, which was 3.5 percent. Moreover, if you look at the pattern of ECI reports this year, there is no sign of an acceleration in that number. Instead we see a very well-behaved employee compensation index.

So again, we believe that fears of a large increase in the inflation rate appear at this point to be unwarranted. However, we do believe strongly that it is critical to our goals that the expansion be one that is sustainable and one with low inflation. This commitment reflects the recognition that it is advisable to safeguard the nation's hard-earned gains on the inflation front. It took a while for this country to get to the present levels of inflation rates, and it was a hard-earned struggle.

We also recognize that the only way to reduce inflationary expectations over the long run is, in fact, to experience a period of sustained growth with modest inflation. That is why we believe that reducing inflationary expectations is the important goal for the economy, and we are working toward this goal through a credible policy of fiscal restraint.

Now, let me turn to the longer-term problems. Earlier, I suggested the three problems we have been trying to deal with. One was the character of the cyclical position of the economy, and clearly that has vastly improved over the last two years. The second was the deficit problem, and I've indicated how we have addressed that. The third was the problem of productivity and faltering median income.

We all know—any serious study or serious government document will show this—that there will be a resurgence of the deficit problem sometime in the next decade. The numbers now look much improved for the rest of this decade, but, certainly, by the middle of the next decade the deficit-to-GDP ratio will start to inch up toward territories that are clearly of concern. The deficit problem, therefore, remains out there as a longer-term problem.

Let me say one other thing we know certainly about this ratio. We know that the major factor driving this number up is health care costs. Nothing else in the federal budget picture is growing at a rate to explain such an increase in the deficit-to-GDP ratio. So we have that problem as a nation confronting us.

Next is the problem of productivity and faltering median family income growth and the issue of a continued decline in compensation at the bottom of the skill distribution that now extends through the middle of the earnings distribution.

One of the most dramatic charts I have seen this year in my tenure as chair of the council is one that showed average productivity growth, average earnings growth, and median earnings growth in the U.S. economy since the late 1970s. Average earnings growth pretty much tracked average productivity growth. When average productivity growth slowed down, average earnings growth also slowed down. But both continued to rise. What did not rise throughout this 15-year period was median earnings growth, which, in turn, is reflected in the fact that median family income did not rise during the period.

Clearly, when economists look at that kind of data, they try to come up with explanations. What has happened to the median worker and the median household in the United States? The main explanation that people have come up with is that a shift in demand toward a highly skilled, highly educated worker—a shift that is attendant on changes in technology and, to a lesser degree, attendant on changes in trade—has resulted in a significant shift in demand away from those with only a high school education.

The problem is 75 percent of workers in this society have only a high school education, and that number has not changed much for new entrants into the work force. Technology and shifts in the demand for labor have made the return to that level of education either stagnant or, when the economy is in a slow-growth period, negative. That, it seems to me, is a major long-run problem that the country faces.

Let me add a special note on this. This week I read with considerable interest a report issued by the Children's Defense Fund. The report was put together by a group of economists, with Nobel laureate Bob Solow as the chair of the group. What the study carefully documented was that poverty among children was a major determinant of how many years of schooling children complete.

We now have in this society a larger number of children in poverty than at any time since 1965. They have a high probability of not getting even a high school education, and therefore, they will not raise their productivity and earnings enough to get themselves and their children out of poverty. This is just one part of what is a bigger problem for this society, namely, how to train and educate people for the jobs of the future, which will require different kinds of skills and technology than the jobs of the past.

So that is my sense of what the major problems confronting the economy in the future are likely to be. They will require serious efforts on out-year deficits, serious efforts on continued investment to increase productivity growth, and serious efforts on the training and skills front.

I think it is important to note that what I have called a voodoo II plan—consisting of a balanced budget amendment, unspecified spending cuts, and unfunded tax cuts—will not work, will not address any of those problems. Even worse, such a plan will undermine the very painful process of credible deficit reduction that in fact is the foundation for a period of sustained growth in the U.S. economy, growth that is necessary to solve the real problems in the economy. Deficit reduction is not sufficient, but it is necessary, and if we undermine credibility and we undermine the path of deficit reduction, I am concerned that we will undermine the sustained period of expansion that we are trying so carefully to craft.

Now let me mention one thing that would not normally be on the agenda for this particular speech, but I feel so strongly about it that I want to end with it. I think it is important for this group as well. In riding to work today I heard a discussion on NPR about the upcoming GATT vote—the General Agreement on Tariffs and Trade. The discussion was about how its failure to pass would be a defeat for Senator Dole and for President Clinton. It was a discussion about their individual political needs and lives.

There is a tendency right now to talk about policy issues in terms of politics. The GATT is a major policy issue. It represents a major economic gain to the United

States and to the world economy, and its defeat would be a defeat for the country and for the world. It doesn't matter whether it's a defeat or a victory for Senator Dole for that matter. It is a defeat for the country and a defeat for the world. This is a historic vote. Not many votes of this significance come along in a century.

Moreover, if the GATT is defeated, the day after the vote will not be like the day before the vote. The day after it is defeated will be a day in which business confidence here and around the world will be undermined. It will be a day in which financial market confidence will be undermined, or at least adversely affected. It will be a day in which the United States will no longer have credibility as the leader of trade liberalization, a position it has held since the end of World War II. This is a major economic and political issue for the United States, and I hope and believe that GATT will be passed. I think it is important to recognize the significance of this vote. It is not just another vote in just another political season. It is a major vote for the country and the world.

SPEAKER

A synopsis of comments by
The Honorable Bill Bradley
United States Senate

It would have been hard to be prepared for the kind of changes that have swept the world in the past few years. I never thought that I would live to see the day when Nelson Mandela was the president of South Africa. I never thought I'd live to see the day that Yitzhak Rabin and Yassir Arafat shared a Nobel Peace Prize. And I certainly never thought I'd see the day when communism in the Soviet Union, and the Soviet Union itself, ceased to exist. Yet, all those things have happened.

On a fundamental level, these examples send us an important message about the possibility for change: that individuals can make a difference and that long-held assumptions can be turned on their heads almost overnight if the right forces come together to bring about change.

Of all the changes I just mentioned, the one I think about most often is the demise of the Soviet Union and the end of the Cold War. This change made the world a much safer place, yet for many it has actually created an era of uncertainty. While, as an American, I feel more secure today because there is no longer a danger that I will be burned to a cinder by a nuclear attack, if I were a defense worker and I had lost my job because missiles are no longer being made, things would be more difficult for me now than during the Cold War. Between 1986 and 1996 4 million Americans will have lost their jobs in the defense sector because of a very positive development: the end of the Cold War.

Another change that's sweeping through our economy at a startling pace is the information revolution. On one level it offers us tremendous opportunities for productivity gains, a cleaner and more prosperous society, and a more efficient economy. These opportunities, however, carry with them significant repercussions for American workers. For example, if you were a steelworker in 1979, you had about 750,000 fellow steelworkers; today, the number is more like 340,000 or 360,000. Yet today we produce and export more steel and import less, because of the application of information to the production process. This is happening not just in the steel industry, but in sector after sector throughout our economy, and it is a reality that policymakers have to understand.

Or take, as another example, the explosion of world markets. A decade ago there were 2 billion fewer people participating in the world market than there are today. Since then we have added not only those who lived in the former Soviet Union and China, but also people in South America and Africa who had lived largely behind protectionist barriers under authoritarian regimes whose major objective was to divide up a shrinking pie among the country's elites. In many parts of the world that era has passed. People are actively seeking capital from a worldwide capital market, and they are looking to export as well as import.

On one level, this is a tremendously hopeful development in terms of the potential for economic growth. I was at a conference about a year ago where I heard a presentation by the Coca-Cola company. Their representative said that the average per capita consumption of Coca-Cola in China is one serving, whereas in the United States the figure is 383. Talk about market potential! And not just for Coca-Cola or McDonald's, but also for heavy capital goods produced in America by American workers, for computers, for software, and for many other goods and services for which we have a true comparative advantage because of the skill of our work force. This means, however, that as you seek access to other markets, your markets have to be open as well. This is another global economic change that policymakers need to recognize.

A fourth change is the explosion of the U.S. federal debt over the last 10 or 12 years, from about $800 billion to $4.3 trillion and headed toward $5 trillion in the next three or four years. This is occurring despite the decisions taken in 1993 that led to a decline in the rate of increase of the deficit and the national debt. The level of this debt is truly a burden on our children's future. It drains what little savings we have away from businesses that want to expand, away from people who want to buy a car or a house or send their kids to college. Before we passed the 1993 act, I asked the GAO, "Well, what would happen if we do nothing?" The answer was "If we do nothing to reduce the debt, by the year 2020 all of our incomes will be 40 percent less than they otherwise would be."

Because of that legislation, we are now marginally better off. We have made a beginning. But we have by no means come to grips with the size of the debt and the volatility that it creates in our economy. Interest rates swing up and down and up and down; the real estate industry goes belly up and doesn't quite recover; inventories aren't quite built up as much as they were before; order times are shortened. Finally, all of the devices that people employ in business in an effort to increase efficiency in an increasingly unpredictable world take a backseat to financing concerns. In the long run this is not necessarily in our national interest.

That brings us to the change that occurred last week—in the elections. This occurred in the context of these other economic changes that are swirling around us: the end of the Cold War, the information revolution, the explosion of world markets, and the gigantic buildup of national debt.

We should be fairly certain that, whatever happens in terms of fiscal policy, monetary policy can more than offset it. My prediction is that Congress will end up not making any dramatic change, but will tinker around the margins so that those who were elected on a platform of change can hold up a sliver of evidence as proof that they are keeping their promises.

When monetary policy is wrong, it is pretty difficult to swim against the tide. I don't pretend to be a monetary economist, or even an economist, but if you look at the situation today, it's hard to understand the rationale for recent interest rate increases. I know that we are supposedly trying to stem inflation, but where is the inflation? A couple of commodities have increased in price a little faster than the rate of inflation, but does that mean that we have to raise rates 75 or 200 basis points? We have to deal with inflationary expectations, but, in reality, this is not what we are doing. Instead, we are really listening to the expectations of the financial community. By dominating public policy, the financial community is controlling the productive capacity of our country.

Interest rates should not be going up. The Fed is charged with two objectives: to promote stable prices and adequate employment, and there will always be a tradeoff. However, I think it is clear that it is the goal of price stability that dominates the Fed's agenda.

The Fed is attempting to make up for the fiscal excesses of the last decade that were responsible for the giant debts and the resulting uncertainty. I would argue that we are now sacrificing and will continue to lose a significant amount of economic activity. This narrow view of monetary policy held by a few reduces the potential for job creation for many. I am not suggesting unleashing unlimited monetary growth or exposing our economy to the ravages of inflation, but I think we are a long way from that situation.

When you are confronted with massive change—whether it's economic transformations, the information revolution, or the recent so-called political revolution, the best course of action is to concentrate on fundamental problems. Don't try to tell people that changes on the margin are going to transform the habits and activities of a lifetime. We need to have a monetary policy that focuses on the long term, but doesn't ignore the importance of job creation in America, and to develop a fiscal policy that systematically addresses the underlying problem of the national debt. If we fail to do that, we're going to end up putting more people out of work.

In conclusion, I believe that the administration understands the situation, and I am hopeful that the new Senate and House leadership will soon see the importance of tackling the issue at its root. I believe that to the extent that we face the underlying reality, we'll all be better off, whether we're economists or politicians.

FORUM

Long-Term Structural Issues of the U.S. Economy

A synopsis of comments and questions by

Judy Woodruff (moderator)
Senior Correspondent, CNN

The Honorable Frank Newman
Deputy Secretary, United States Department of the Treasury

Deputy Secretary of the Treasury Frank Newman spoke about current economic conditions and related accomplishments of the past two years and some of the goals for next year, including the continued reduction in the budget deficit, stabilization of the increase in the national debt, and the continued downsizing of the federal government. He also noted the significance of accurately measuring and analyzing economic data and stressed the importance of approving the Uruguay Round of the GATT, which he described as being in the best interest of the United States and of our children.

The fundamentals of the economy—characterized as moderate economic growth, low inflation, and job creation—look good. The number of jobs created in the United States between 1993 to 1994 outpaced the combined job creation in England, France, Germany, Italy, Canada, and Japan.

In addition, the budget deficit was reduced without the aid of accounting gimmicks. In fiscal year 1994 the deficit shrank to $203 billion, far lower than the $300 billion previously forecast. Furthermore, the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) agreed that the deficit will be reduced to $170 billion in fiscal year 1995, which will be the third consecutive year of deficit reduction and the first time that this feat will have been accomplished since Harry Truman was president.

Mr. Newman also discussed problems with economic assumptions that underlie data definitions. In a recent *Business Week* article on problems with the government statistics used in measuring the economy, investment statistics were judged to be understated and the consumer price index overstated (as compared to actual *ex post* changes).

Another another type of discrepancy in data definitions occurs in the recording of purchases of motor vehicles versus lease agreements. Buying a car is measured as consumption, while leasing is recorded as investment. Similarly, the purchase of additional aircraft to expand airline capacity is considered investment, while the government construction of a new runway to deal with air traffic congestion is considered consumption.

In a related vein, savings and the real flow of money are different in that an increase in savings is not necessarily associated with a rise in investment. The important factors associated with the investment decision are the demand for investment and an environment conducive to investment.

Judy Woodruff, senior correspondent for CNN, asked if the Treasury Department had begun to look at the question of a middle-class tax cut, noting that President Clinton had recently stated that he would be in favor of such an action as long as there were a way to pay for it. Mr. Newman responded that Treasury had not analyzed Representative Archer's proposal for a consumption tax.

In response to Ms. Woodruff's question regarding the possible effects that a balanced budget constitutional amendment might have on the policies the administration is pursuing, Mr. Newman stated that the administration opposed such an amendment during the previous session of Congress because of concerns about its details. Although much of the idea sounds great, and although in a fiscal sense the Congress and the administration share a lot of objectives, if the particulars about exactly how measures are defined and under what circumstances exceptions are made are not spelled out, we cannot know how the budget would be affected.

A budget, after all, is just an estimate; it is a set of projections that are done in certain ways under certain definitions. Things can change within the context of those definitions. Without such detail, a meaningful statement about such a broad concept is difficult. In addition, he noted that he would not want to see legislation that would eliminate the flexibility of policymakers, especially during a recession.

When Ms. Woodruff asked whether it was realistic to talk about moving to a zero deficit by the year 2002, Mr. Newman responded that that was a question that needed further study. He noted that the deficit reduction accomplished thus far had been extremely difficult, but that some actions short of a balanced budget amendment, such as a line-item veto, might make it easier to further reduce spending.

Mr. Newman also attributed the progress in stabilizing the increase in the national debt to the 1993 budget agreement. Without this agreement, the debt-to-GDP ratio, now at 50 percent, would have continued to rise. There have been times in the past when the ratio has been higher, most notably at the end of World War II, when the national debt was greater than 100 percent of GDP. The ratio is projected to be relatively flat until the turn of the century, when it is projected to rise because of the expected increase in health care costs. For this reason, Mr. Newman noted that there was a need to revisit health care reform. Although there was no magic number for this ratio, Mr. Newman stated that it was perilous to have an ever-increasing ratio and that it was necessary to be cautious about the trend.

Ms. Woodruff then shifted the discussion from fiscal to monetary policy by asking whether Mr. Newman could give a broad assessment of the move the Federal Reserve made on November 15 to raise both the discount and the federal funds rates.

Mr. Newman responded that he did not "want to get into the business of second-guessing the Fed." He stated that the administration shares the ultimate objectives of improving the economy and having stable long-term growth with low inflation. The judgments that are made by the Federal Reserve, which is an independent agency, about exactly how to achieve that were not something that he was prepared to comment on.

When Ms. Woodruff asked whether higher interest rates are helpful to the policies the administration is pursuing, Mr. Newman replied that "we're back to this issue about assumptions and projections and nobody knowing the right answer for sure. To the extent that the economy might have grown so rapidly that there would be significant conflict for limited resources and, therefore, inflation without the dampening by the Federal Reserve, then it's the right answer. To the extent it turns out that, in hindsight, the economy was not really headed for that kind of tremendous conflict for limited resources and, therefore, not for inflation, then [the Fed's actions] will turn out to have been unnecessary and maybe harmful. Again, I don't want to get into the position of trying to second-guess these judgments."

Ms. Woodruff then inquired whether Mr. Newman agreed that it's easier, as some would argue, for the Fed to err in the direction of tightening than to correct in the other direction. Mr. Newman replied that "certainly everybody wants to avoid a crash. One of the great concerns is if [the economy] does overheat; you'd hate to see the kind of situation we've seen before where the Federal Reserve feels obliged to raise interest rates very high." That is, everyone would like to avoid the situation of experiencing another 20 percent prime rate scenario and a real recession as a result.

Mr. Newman continued by stating that "the judgment as to exactly what the right moves are is very delicate. At some point in time we hope that this economy is going to grow on a sustained basis for a long, long period of time. But again, history has shown us that there are cycles, and at some point in time the Federal Reserve needs to loosen. They're going to have to make judgments about the leads and the lags; one of the things that complicate things so much is the time it takes for any monetary policy action to really be felt throughout the economy. The Federal Reserve puts a lot of effort into trying to understand the trends, trying to model things. They make the best judgments they can."

ROUNDTABLE

Monetary Policy and Its Relationship to Economic Growth

A synopsis of remarks by

Susan Dentzer (moderator)
Chief Economics Correspondent, *U.S. News & World Report*

Jerry J. Jasinowski
President, National Association of Manufacturers

John Makin
Senior Resident Fellow, American Enterprise Institute

Lynn R. Williams
Former President, United Steelworkers of America

Susan Dentzer, chief economics correspondent for *U.S. News & World Report*, prefaced the discussion by stating that those who care deeply about monetary policy in this country hold several truths to be virtually self-evident. First, the Fed has one of the two great levers that government has available to it to influence the course of the economy, namely, monetary policy.

Second, the Fed must wield this tool in an ever-changing economy where history does not repeat itself and where the Fed constantly has to sift the evidence to determine what shape the economy is in and where it is going.

Third, the Fed is the guardian of price stability, the soundness of the currency, and the safety and the efficiency of the banking system, although these are not ends in and of themselves; rather, they are means to the end of having a growing economy that will constantly lead the country toward improving living standards for as many Americans as possible.

Fourth, the Fed's job is, by its very nature, fraught with peril. It cannot wait to shoot until it sees the whites of inflation's eyes; it must shoot well in advance of that. Yet if the Fed makes big policy errors on either side, either allowing too much inflation to build up in the economy or bearing so hard down on the economy as to cause unnecessarily slow growth or recession, it wreaks havoc.

Thought about recent Fed tightening falls into two schools, one that believes that the monetary authority has acted too harshly and one that believes that the Fed's actions have been necessary to dampen future inflation. Ms. Dentzer characterized the first school of thought in terms of a newly defined economy in which the old relationships between economic variables no longer hold. Advocates of this school do not see inflation as a threat despite the current performance of the economy. Shortages in the labor sector are primarily for skilled workers, which has limited traditional inflationary pressures originating in these quarters. Moreover, intense competition in both domestic and global markets prevents U.S. producers from passing along price increases to consumers. Finally, production in the newly structured economy is much more efficient than in the past; rates of capacity utilization of 84 or 85 percent, therefore, no longer imply that production bottlenecks will soon occur, but rather that resources are being utilized in their most productive manner.

According to the older school of thought, today's growth is a precursor to imminent wage pressure that will soon translate into an inflationary spiral and in which higher capacity utilization implies bottlenecks, excess demand, and increases in producer prices, all of which will render higher rates of inflation.

Comments reflecting the newer school of thought were offered by Jerry Jasinowski, president of the National Association of Manufacturers. Mr. Jasinowski asserted that there is no evidence indicating inflationary pressures. While a few instances of increasing commodity prices might be found, they do not portend a rise in future inflation because firms are striving to increase market share, which prevents them from passing on any such increases. In addition, increased competition and rising productivity in labor markets prevent wage costs from escalating, while outside economies are exerting deflationary forces on the U.S. economy. Finally, capacity utilization rates do not accurately predict rising future prices in the new economy. The figures include only a vague measure of investment, are not updated frequently enough to take new investment into account, and have no capability of looking at the nature of investment. Manufacturers generally regard the capacity utilization index as an amusing anachronism, not something that tells much about capacity.

The nature of today's economy, therefore, prevents what appears to be inflationary pressures from translating into actual price increases.

The new economic structure has several macroeconomic implications: Dramatic productivity improvements in manufacturing of about 3 percent per year (in part the result of increased productivity gains) have raised output potential between 2.5 and 3.0 percent. Also, changes in the labor force (reflected in the larger number of part-time workers and rising competition for jobs) have lowered the natural rate of unemployment considerably below 6 percent. These combined factors signify that there is no significant wage pressure in the manufacturing sector and a lack, then, of evidence for the need for a preemptive strike on inflation by the Federal Reserve.

Others, however, believe that traditional links between economic variables still exist and that changes in those variables, therefore, will result in escalating inflation. John Makin, senior resident fellow at the American Enterprise Institute, pointed to rising intermediate goods prices, wage pressures, and the closure of the GDP gap as evidence that inflationary pressures exist and as reasons the Fed was justified in raising rates. Moreover, in contrast to the claims of the new economic structure school of thought, the current expansion has indeed been a typical one except for a more moderate-than-usual rate of growth during the early part of the cycle. Growth was eventually stimulated, however, by unusually low interest rates (long-term rates as low as 5.8 percent, for example) early in the expansion. At this point in the cycle, however, the Fed is correct in trying to cool growth to a sustainable level (approximately 2.5 to 3.0 percent). Intermediate goods prices have risen 4.1 percent over the last year, or 7.4 percent if annualized over the last three months. This implies accelerating inflationary pressures in the pipeline, which will put pressure on firms to raise output prices.

Dr. Makin further justified the Fed's preemptive strike based on recent movements in the consumer and producer price indexes. If the Fed were to wait until the CPI were rising at a 4 to 5 percent rate, it would be too late to slow things down without having to take even more stringent actions. In such circumstances, we would experience considerably higher rates of inflation before the economy cooled sufficiently for prices to decline.

Inflationary pressures are also being exerted in the labor market, as evidenced by the 2.9 percent increase in hourly earnings over the last year. Annualized over the last six months, the figure reaches 3.5 percent; annualized over the last three months it is 4.8 percent.

While granting that capacity utilization is not a good gauge of inflationary pressure, Dr. Makin stated that the GDP gap is. The 3.4 percent growth rate posted in the third quarter closed the gap [the difference between actual and potential output], leaving no room for further expansion without a rise in inflation.

Based on most empirical evidence, Dr. Makin noted that he expects inflation to expand in early 1995, with the CPI rising at approximately a 4 percent annual rate. If this is indeed a normal recovery, the Fed therefore still has a long way to go to tame inflation. Long-term rates have not yet declined, indicating that the yield curve has not yet flattened; this implies that the federal funds rate will have to increase by another two percentage points before inflation is under control.

Lynn R. Williams, former president of the United Steelworkers of America, offered a different perspective, one that he claimed was "that of American working people." Mr. Williams stated that claims that the economy was so hot that it needed to be cooled "defied credibility." Although recent performance has improved, the economy had been in such a poor state, especially in the eyes of manufacturing workers, that it had a long way to go to catch up to where it was before the past recession. Although overall unemployment is declining, there are still over 7.5 million people out of work, and unemployment rates are still very high for specific groups, such as black youth. There also are large numbers of hidden unemployed: workers taking early retirement because of a lack of job opportunities, those taking part-time and contingency work because they cannot find full-time employment, and discouraged workers no longer seeking employment.

In addition, the quality of jobs has a long way to go in order to make up for ground lost in the not-so-distant past. Although recent gains have been posted in the number of good jobs secured, this was the first improvement in that area in some time. Evidence of this is found in the fact that family incomes have been declining, which has led to the polarization of the United States and the hollowing out of its middle class. Incomes in the United States are lower than those in most other industrialized countries, yet those countries are still able to be competitive on an international scale. There is, therefore, a firm need to generate employment for all, not only for those at the top of the income distribution.

Mr. Williams believes that the real answer to inflation, then, is to improve productivity, the volume of output, and our relationships with other countries. This translates into additional investment in private sector plant and equipment, infrastructure, and people.

Ms. Dentzer asked Mr. Jasinowski whether rising intermediate goods prices would result in manufacturers' passing these costs on in the form of higher finished goods prices. He responded that intermediate goods are only a part of total production costs. Moreover, in addition to being highly cyclical, commodity goods prices do not reflect full production costs. Finally, over one-third of manufacturers have said that even if their costs rose, in order to remain globally competitive, they would not increase prices.

Dr. Makin was skeptical of this assertion. Rising labor costs (which represent two-thirds of total production costs), booming Asian and Latin American economies (from which the United States imports much of its raw materials), rising world demand, and high capacity will stoke worldwide inflationary pressures.

In response, Mr. Jasinowski noted that while there has been a little pressure on worldwide wage compensation, there has been no significant increase in labor costs. Mr. Williams noted that even if wages rise after a long period of moderate growth, they will still not approach the levels prior to the concessions posted in the mid-1980s.

Questioned by Ms. Dentzer about the extent to which the Fed should factor employment into its decision making, Dr. Makin noted that "there is very little evidence that monetary policy has any effect on reducing the unemployment rate over a period of time of greater than a year." The role of the Fed, then, is to maintain stable prices and not to worry about unemployment. This view is "reinforced in that description of their job by a large body of professional evidence with which most economists agree: that there is no sustainable way to help unemployment with monetary policy."

Mr. Williams argued, however, that the point of raising interest rates is to slow economic activity, which eventually affects jobs. Approaching the question a bit differently, Mr. Jasinowski noted that even if we temporarily accept the argument that monetary policy cannot have a major effect on unemployment in the short-term cyclical sense, the Fed is still targeting growth, and growth and jobs are intrinsically related.

Countering these arguments, Dr. Makin stated that the Fed does not target growth per se. He reiterated his view that the Federal Reserve can affect interest rates in the long run, but not unemployment. In addition, the Fed is not targeting growth and therefore not altering employment.

The question of the Federal Reserve's role in affecting employment is often brought up in context of the Humphrey-Hawkins Act. An audience member asked whether the act should be modified to exclude the unemployment target for the Fed mandated in the act. Mr. Jasinowski argued that the notion that we can solve a problem as complex as unemployment by legislatively removing it as a mandate for the Fed is silly and that amending the Humphrey-Hawkins Act will not make the problem of unemployment disappear.

A question was raised about Dr. Makin's comments that higher long-term interest rates will occur if we lower short-term interest rates, but also if we raise short-term rates. The audience member asked if there was anything that would not lead to higher long-term interest rates. Dr. Makin responded that in a world where the demand for credit is growing rapidly, you can affect the sequence with which long-term interest rates move up, but right now you cannot prevent their rise.

CONFERENCE PARTICIPANTS

Monetary Policy: The Inflation-Unemployment Tradeoff

The Jerome Levy Economics Institute of Bard College

November 17, 1994
Washington, D.C.

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The Jerome Levy Economics Institute of Bard College
Annandale-on-Hudson, New York 12504-5000

The Jerome Levy Economics Institute of Bard College
cordially invites you to a conference on

Monetary Policy:
The Inflation-Unemployment Tradeoff

November 17, 1994

Grand Hyatt at Washington Center

Monetary Policy: The Inflation-Unemployment Tradeoff

The objective of the Institute's second conference in Washington, D.C. is to explore the impact of monetary policy on inflation and unemployment. The formal presentations and discussion will provide an analysis and assessment of the Federal Reserve's actions as they relate to the issues of economic opportunity, wage structure, financial stability, and long-term growth. At the top of the agenda are such questions as what the Federal Reserve's mandate should be for setting monetary policy; how to achieve a balance between "stable" prices and "full employment" (and the definitions of those terms); and how to reconcile the needs of consumers and borrowers with the concerns of markets and investors.

Founded in 1986, the Institute is an autonomous, independently endowed research organization. It is nonpartisan, open to the examination of diverse points of view, and dedicated to public service.

November 17, 1994

Grand Hyatt at Washington Center

1000 H Street, N.W.

Washington, D. C.

R.S.V.P. by November 10, 1994

For additional information, call 914-758-7700 or fax 914-758-1149.

Thursday, November 17

8:30 am	REGISTRATION
9:00 am	Opening Remarks by **Dimitri B. Papadimitriou,** Executive Director, The Jerome Levy Economics Institute and Executive Vice President, Bard College
9:15 am	PRESENTATION: **David A. Levy,** Vice Chairman and Director of Forecasting, The Jerome Levy Economics Institute
9:45 am	DIALOGUE: *Public Policy Perspectives on Monetary Policy*
	Judy Woodruff (moderator), CNN
	The Honorable Frank Newman, Deputy Secretary, U.S. Department of the Treasury
	The Honorable Phil Gramm*, United States Senate
11:00 am	PRESENTATION: **The Honorable Laura D'Andrea Tyson,** Chair, President's Council of Economic Advisers
12:00 noon	LUNCHEON Speaker: **The Honorable Bill Bradley,** United States Senate
1:45 pm	ROUNDTABLE: *The Federal Reserve and Monetary Policy: Main Street vs. Wall Street?*
	Susan Dentzer (moderator), Chief Economics Correspondent, *U.S. News & World Report*
	Jerry Jasinowski, President, National Association of Manufacturers
	The Honorable Lawrence B. Lindsey, Board of Governors of the Federal Reserve System
	Lynn R. Williams, former President, United Steel Workers of America

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The Jerome Levy Economics Institute of Bard College

A Conference of

The Jerome Levy

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of Bard College

MONETARY POLICY:

The Inflation-Unemployment Tradeoff

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The Jerome Levy Economics Institute of Bard College

MONETARY POLICY:
The Inflation-Unemployment Tradeoff

Recent policy actions by the Federal Reserve have rekindled national debate over the appropriate course for monetary policy. Citing inflationary pressures on the horizon and uncertainty resulting from the rapid pace of technological change, the globalization of finance, and the evolving structure of financial markets, the Federal Reserve commanded five increases in the federal funds rate from February through October of 1994.

The objective of the Institute's second conference in Washington, D.C., is to explore the impact of monetary policy on inflation and unemployment. The formal presentations and discussion will provide an analysis and assessment of the Federal Reserve's actions as they relate to the issues of economic opportunity, wage structure, financial stability, and long-term growth. At the top of the agenda are such questions as what the Federal Reserve's mandate should be for setting monetary policy; how to achieve a balance between "stable" prices and "full employment" (and how to define those terms); and how to reconcile the needs of consumers and borrowers with the concerns of markets and investors.

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PARTICIPANTS

The Honorable Bill Bradley, *U.S. Senate*

Susan Dentzer, *Chief Economics Correspondent,* U.S. News & World Report

Jerry J. Jasinowski, *President, National Association of Manufacturers*

David A. Levy, *Vice Chairman and Director of Forecasting, The Jerome Levy Economics Institute*

The Honorable Lawrence B. Lindsey, *Member, Board of Governors of the Federal Reserve System*

The Honorable Frank Newman, *Deputy Secretary, U.S. Department of the Treasury*

Dimitri B. Papadimitriou, *Executive Director, The Jerome Levy Economics Institute and Executive Vice President, Bard College*

The Honorable Laura D'Andrea Tyson, *Chair, President's Council of Economic Advisers*

Lynn R. Williams, *former President, United Steel Workers of America*

Judy Woodruff, *Senior Correspondent, CNN*

CONFERENCE PROGRAM

THURSDAY, NOVEMBER 17

8:30 a.m. *REGISTRATION*

9:00 a.m. *OPENING REMARKS:* ***Dimitri B. Papadimitriou,*** *Executive Director, The Jerome Levy Economics Institute and Executive Vice President, Bard College*

9:15 a.m. *PRESENTATION:* ***David A. Levy,*** *Vice Chairman and Director of Forecasting, The Jerome Levy Economics Institute,* The Federal Reserve: Securing Our Future or Jeopardizing It?

9:45 a.m. *FORUM:* Long-Term Structural Issues of the U.S. Economy

Judy Woodruff *(moderator), Senior Correspondent, CNN*

The Honorable Frank Newman, *Deputy Secretary, U.S. Department of the Treasury*

11:00 a.m. *PRESENTATION:* ***The Honorable Laura D'Andrea Tyson,*** *Chair, President's Council of Economic Advisers*

12:00 noon *LUNCHEON*

Speaker: ***The Honorable Bill Bradley,*** *U.S. Senate*

1:45 p.m. *ROUNDTABLE:* Monetary Policy and Its Relationship to Economic Growth

Susan Dentzer *(moderator), Chief Economics Correspondent,* U.S. News & World Report

Jerry J. Jasinowski, *President, National Association of Manufacturers*

The Honorable Lawrence B. Lindsey, *Member, Board of Governors of the Federal Reserve System*

Lynn R. Williams, *former President, United Steel Workers of America*

PARTICIPANTS

Bill Bradley *is the senior United States senator from New Jersey. In the Senate, he has been active on tax and economic issues and is a member of the Senate Finance Committee and chairman of the Subcommittee on Debt, Deficits, and Long-Term Growth. He is also a member of the Energy and Natural Resources Committee and the Special Committee on Aging. Bradley was the author of the Tax Reform Act of 1986 and the 1993 Urban Community-Building Initiative. Before entering the Senate in 1979, he had a distinguished academic career—capped by a Rhodes Scholarship to Oxford University—and was an exceptional athlete. He won the Sullivan Award as America's outstanding amateur athlete, and in 1964 was the captain of the gold-medal–winning U.S. Olympic basketball team. After Oxford, Bradley joined the New York Knicks, who won the National Basketball Association championship in 1970 and 1973 with him as a starting forward. He did his undergraduate work at Princeton University and earned a graduate degree from Oxford University.*

Susan Dentzer *is the chief economics correspondent and economics columnist for* U.S. News & World Report. *Her specialties include political-economic concerns, such as U.S. fiscal and monetary policy; international economic issues, including U.S.-Japanese relations; and domestic policies, such as the growth of Medicare and other entitlement programs. She also appears frequently on television and radio. Dentzer received a Nieman Fellowship for 1986–87 and a U.S.- Japan Leadership Program Fellowship in 1991. She was a senior writer covering business news for* Newsweek *before beginning her Nieman year at Harvard and joined* U.S. News *after that year. She graduated from Dartmouth College.*

Jerry J. Jasinowski *is the president of the National Association of Manufacturers. He began his career as an Air Force intelligence officer, serving in the Far East in the mid-1960s. He then became assistant professor of economics at the U.S. Air Force Academy and eventually moved to Washington to manage research and legislative activities for the Joint Economic Committee of Congress. Jasinowski directed the economic transition team for the incoming Carter administration in 1976, coordinating the departments of Treasury, Commerce, and Labor, the President's Council of Economic Advisers, and the Federal Reserve. He was subsequently appointed assistant secretary for policy at the U.S. Department of Commerce. In January of 1990 he became president of the NAM, after serving earlier as the association's executive vice president and chief economist. He took his B.A. at Indiana University and his M.A. at Columbia University and is a graduate of the Harvard Business School's Advanced Management Program.*

David A. Levy *is vice chairman of The Jerome Levy Economics Institute and director of the Institute's Forecasting Center. Since 1978 he has been co-author of* Industry Forecast, *America's oldest paid-circulation monthly economic newsletter. He is also the author of* Profits and the Future of American Society *and has been widely quoted by, among others,* Forbes, Business Week, Financial World, The New York Times, *and* Time. *Levy has made numerous appearances on television and radio. In 1992 he was named to the Public Infrastructure Subcouncil of the Competitiveness Policy Council. He is a graduate of Williams College and received an M.B.A. from Columbia University Graduate School of Business.*

Lawrence B. Lindsey *is a governor of the Federal Reserve Board. His doctoral thesis in economics received the National Tax Association's Outstanding Doctoral Dissertation Award in*

1985, and in 1988 he was named the Citicorp/Wriston Fellow of the Manhattan Institute for his research. He is a former professor of economics at Harvard University. He served three years as senior staff economist for tax policy on the President's Council of Economic Advisers during the Reagan administration. Immediately prior to joining the Federal Reserve Board, Lindsey was a special assistant to the president for policy development. Lindsey received his B.A. from Bowdoin College and his M.A. and Ph.D. from Harvard University.

Frank Newman *is the deputy secretary of the Treasury. Before joining the Treasury Department he worked in the private sector as a manager of the Boston office of Peat Marwick, Livingston & Co. in the late 1960s. From there he went to Citicorp, where he was a vice president, and thence to Wells Fargo, where he became executive vice president and chief financial officer in 1980. Six years later he moved to BankAmerica, where he was chief financial officer and vice chairman of the board of directors. His first assignment at Treasury began in 1993, when he became under secretary for domestic finance, with responsibility for the development of policy and activity in the areas of management of the public debt, financial institutions and their regulation, and financial management services. He was instrumental in the creation and passage of legislation on community development financial institutions and interstate banking, as well as on other matters. Newman received his B.A. from Harvard University.*

Dimitri B. Papadimitriou *is the executive director of The Jerome Levy Economics Institute and the executive vice president of Bard College. He is also Levy Institute Professor of Economics at Bard College. He was Visiting Scholar at the Center for Economic Planning and Research (Athens, Greece) and a Wye Fellow at the Aspen Institute. Papadimitriou is a member of the Competitiveness Policy Council's Subcouncil on Capital Allocation. He is the editor of several books, including, with Edward N. Wolff,* Poverty and Prosperity in America at the Close of the Twentieth Century *and, with Steven M. Fazzari,* Financial Conditions and Macroeconomic Performance: Essays in Honor of Hyman P. Minsky. *Papadimitriou is also co-author, with L. Randall Wray, of "Flying Blind: The Federal Reserve's Experiment with Unobservables" (Levy Institute* Public Policy Brief *No. 15). He is a member of the editorial board of the* Eastern Economic Review. *Papadimitriou received his Ph.D. from the Graduate Faculty of the New School for Social Research.*

Laura D'Andrea Tyson *is chair of the President's Council of Economic Advisers, a cabinet position. She is currently on leave from the University of California at Berkeley, where she is professor of economics and business administration, director of the Institute of International Studies, and research director of the Berkeley Roundtable on the International Economy. She has been a visiting scholar at the Institute for International Economics and a member of the Cuomo Commission on Trade and Competitiveness, the Advisory Board of the Economic Strategy Institute, the Conference Board Economics Colloquium, the Economic Policy Institute Research Council, the Council on Foreign Relations, and the Subcommittee on a Global Economic Strategy for the United States. Among her many publications are* Who's Bashing Whom? Trade Conflict in High Technology Industries; The Dynamics of Trade and Employment; Politics and Productivity: The Real Story of How Japan Works; *"The Economic Black Hole" (with Lester Thurow); and* Power, Purpose and Collective Choice: Economic Strategy in Socialist States. *She received her B.A. from Smith College and a Ph.D. in economics from the Massachusetts Institute of Technology.*

Lynn R. Williams *is the former president of the United Steel Workers of America. After serving in the Canadian Navy in World War II, he began his labor career as an organizer for the Canadian Congress of Labor. He joined the Steel Workers in 1947 and became a staff representative in 1956. In 1973, he became the director of District 6 (Toronto) and moved into the international leadership four years later, as international secretary. From 1983 to 1994, Williams served as president of the international union. In 1983–84 he was also a member of the AFL-CIO Executive Council. His other memberships include the Competitiveness Policy Council, the National Planning Association, the Economic Policy Institute, the National Institute for Dispute Resolution, and the Institutes for the Achievement of Human Potential. He received a B.A. from McMaster University in Canada.*

Judy Woodruff *is CNN's prime anchor and senior correspondent. She can be seen each weekday on* Inside Politics, *the nation's only daily television program devoted exclusively to politics, and on* The World Today, *an hour-long program that examines the major stories and issues around the world. She is also the co-anchor for CNN's coverage of special events such as political conventions and summits. She has been in Washington since 1977, when she became White House correspondent for NBC News. Woodruff has covered every presidential campaign (and political convention) since 1976. Before joining CNN in 1993, Woodruff spent ten years as chief Washington correspondent for* The MacNeil/Lehrer NewsHour. *During that time she moderated the 1988 vice-presidential debate and covered presidential conventions and campaigns. Among the most recent of her awards is the inaugural "President's 21st Century Award" from the National Women's Hall of Fame. Woodruff is a graduate of Duke University.*

Jerome Levy 1882–1967

"If you were unemployed and were willing to work and able to work and could find no work, what would you do?"

The question was directed to William Howard Taft, candidate for the presidency.

"God knows," Taft replied, "I don't." The United States was in the midst of the economic "panic" of 1908 and the future president had just completed a campaign speech.

Jerome Levy, 26-year-old head of a small wholesale business, read about the incident in his newspaper. Levy, an erstwhile student of physics, mulled over Taft's candid admission and the problem of the unemployed.

That morning Jerome Levy began to study economics. He believed that a man who is willing and able to work should have an opportunity to work.

As a businessman, he understood that his own decisions to employ workers were directly dependent on the profitability of his business. He thus approached the problem of unemployment by seeking to determine the sources of profits—not just for a single firm, but for the entire economy.

Levy dedicated his spare time between 1908 and 1914 to his quest. He arrived at an equation for the sources of profits—a version more detailed but otherwise identical to the profit identity later rediscovered by the Polish economist Michael Kalecki and noted by John Maynard Keynes.

Jerome Levy saw the profit equation as the core of a powerful perspective on the operation of an economy, as the best way to understand the dynamics of the system. His own experience strengthened his conviction. During the next decade and a half he was remarkably successful at forecasting economic conditions and managing his business accordingly. His analysis prompted him to liquidate his business and all stock market holdings in the spring of 1929.

Jerome Levy continued his studies and carried on extensive correspondence regarding economic issues with government officials and other influential individuals in the United States and abroad.

The Institute carries on in the spirit of Jerome Levy's efforts to overcome economic problems and improve the human condition.

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